Saskatchewan Economic and Financial Report

March, 1987

Saskatchewan
Finance

The Hon. J. Gary Lane, Q.C.
Minister of Finance

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Preface

This Economic and Financial Report has two objectives:

- to describe the state of our economy and government finances; and,
- to inform the public of the Government's plan to restructure its financial affairs to control and reduce Saskatchewan's deficit.

Saskatchewan has a financial problem. Revenue growth continues to lag behind expenditure growth. Today, health care expenditures alone exceed government revenues from sales taxes and personal income tax. In order to prevent our financial position from worsening and to protect the quality of our health, education and social services, the Government will be introducing responsible and realistic measures to improve further the management of the public purse.

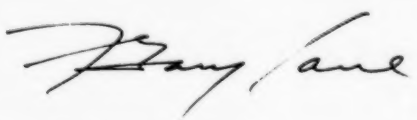
Improving further the financial management of government provides us with challenges and opportunities. We are challenged to examine rigorously our priorities; to spend public monies even more wisely; to ensure higher government productivity; and, to direct assistance to those in need.

We have the opportunity to control our deficit so that we can direct our economic future; to invest more in our future; to build and diversify the economy; and, to assist our farmers through the economic downturn that has affected the agricultural industry.

We are an export-based economy competing in an international market environment characterized by trade-distorting subsidies, predatory pricing and unilateral trade barriers. We believe that the provincial economy can compete and grow in this environment through measures designed to ensure sound financial management, the development and diversification of the economy and through actions at home and abroad designed to defend and expand our essential trading interests.

We believe in Saskatchewan's future. We are convinced that the actions we take now will improve permanently the management of public funds, while providing us with the financial flexibility to protect our province's economic future.

In the weeks and months to come, the Premier, my Cabinet colleagues and I will elaborate on the measures outlined in this Report as we continue to streamline and rationalize the operation of Government.



J. Gary Lane, Q.C.
Minister of Finance

Introduction

It is the responsibility of government to lead by adapting to changing conditions in order to protect its citizens and to offer them opportunities for the future.

In the first half of the 1980s, the Government had reason to believe that our deficit was generated by a cyclical downturn in the economy. It was reasonable to assume that the increase in government expenditures and the sharp drop in our revenues reflected the boom and bust cycles that have long characterized our agriculture and resource-based economy.

If the provincial deficit had been caused by a temporary downturn in the economy, our deficit would not be of concern. Such temporary deficits are based on sound fiscal management principles. They serve to cushion economic fluctuations and dwindle as the economy recovers. However, it is now clear that Saskatchewan's deficit is not a short-term phenomenon and, as such, it threatens the economic and financial well-being of our province.

Not long ago, the so-called "resource boom" was hailed as our economic passport to the future. We now know that this was not the whole truth.

- Realized net farm income in Saskatchewan has dropped nearly 45 per cent from 1981 to 1986 due to drought, grasshopper infestations and a sharp decline in world grain prices. Today, Saskatchewan's realized net farm income is positive only because of government-established programs.
- The potash industry is currently producing at about 65 per cent of capacity and prices have dropped from nearly $155 per ton in 1981 to under $80 per ton in 1986 — a decrease of almost 50 per cent.
- Uranium has suffered a similar fate with spot prices falling from $50 per pound in 1978 to around $24 per pound in 1986 — a drop of over 50 per cent.

During this period, Saskatchewan experienced an oil boom unprecedented in its history. Oil revenues did much to ameliorate the difficulties experienced in our other commodity sectors. This has changed. Oil prices have dropped from a high of $42 per barrel in 1985 to a low of $14 per barrel in 1986.

Today, we are confronted by a situation that was unthinkable in the 1970s. Events beyond our control have resulted in the decline of prices for all our basic commodities on world markets. And as our commodity prices have dropped so has our provincial revenue, while expenditure demands have increased. The provincial deficit for 1986-87 is now expected to be $1.2 billion. If this trend were to continue, we would have an annual deficit of over $2 billion by 1990-91.

We are living through a period of profound economic transformation and the sharp downturn in our commodity prices and the expanding deficit illustrate the new realities in the world today. We cannot ignore these realities and act as if nothing has happened. They affect all of us. As times change, governments must adapt and lead. We must be realistic. Saskatchewan is not an economic island and, therefore, like the other Western provinces, we are not immune to the international adjustments taking place.

The Government will lead by example as it implements its deficit reduction strategy. Before we ask others to sacrifice, we will ensure that our house is in order. The Government will take significant measures to increase government productivity and to spend public funds even more wisely.

An intensive process has already begun that, when completed, will have a dramatic effect on the cost effectiveness and efficiency of public expenditures. This process includes reviews of public sector wage costs, the structure of government departments, agencies and programs and the feasibility of disengaging the government from certain

sectors of the economy. As indicated in the Speech from the Throne, those activities and services that can be better managed by the private sector will, wherever possible, be transferred.

However, in addressing the need to improve public sector efficiency and effectiveness, the Government is not about to compromise its goals of economic diversification and development and protection. Indeed, we reaffirm these basic objectives. We will maintain our commitment to the needy and we will be guided by the rules of fairness and equity. But at the same time the Government will not shrink from its responsibility to make difficult decisions where required. We will work co-operatively with individuals, institutions and industries to adapt to the new environment.

This Report explains why we must streamline the administration of government to control public expenditures and why we are determined to do what has to be done to protect Saskatchewan's future.

The State of the Saskatchewan Economy

The World Economy

The 1980s have witnessed profound changes in the structure of the world economy. The economic and fiscal practices that governed the global economy now seem obsolete. The United States, once the leading creditor nation, has in a few short years, become the largest debtor nation. West Germany and Japan, so often admired for their "economic miracles", are now resorting to a host of measures to stimulate their flagging economies.

Brazil, Mexico and other developing nations are unable to meet interest charges on their public debt and have been compelled to restructure their debt payments several times during the past few years. Brazil's recently announced debt moratorium further underscores the fragility of the world financial system.

As commodity prices plummet, nations long associated with free trade have resorted to trade barriers and extensive networks of subsidies and grants. In the United States, for example, pressures for import controls on steel, agricultural products, lumber, potash and uranium continue to gain public support. Today, the international trading environment is much more hostile and volatile.

Saskatchewan in the World Economy

How does this economic transformation affect us? As a province whose economy is heavily dependent on primary exports, Saskatchewan is particularly vulnerable to changes in world markets. Nearly 45 per cent of our production is exported; grain, oil and potash account for approximately 70 per cent of the province's total exports. Any sharp decline in the prices paid for these exports or a loss of market share directly affects our economic performance and reduces provincial revenues.

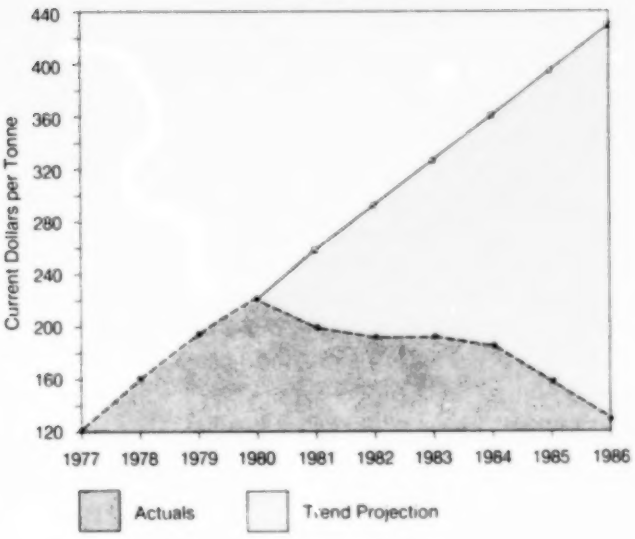
During the 1970s, increases in prices received for Saskatchewan wheat, oil, potash and uranium exceeded inflation and contributed greatly to our economic development. While there were year-to-year fluctuations in commodity prices, the overall export performance of our commodities was strong and led to expenditure decisions based on the assumption of higher commodity prices.

For example, in 1981, the then Minister of Finance projected growth in resource revenues that substantially exceeded actual performance:

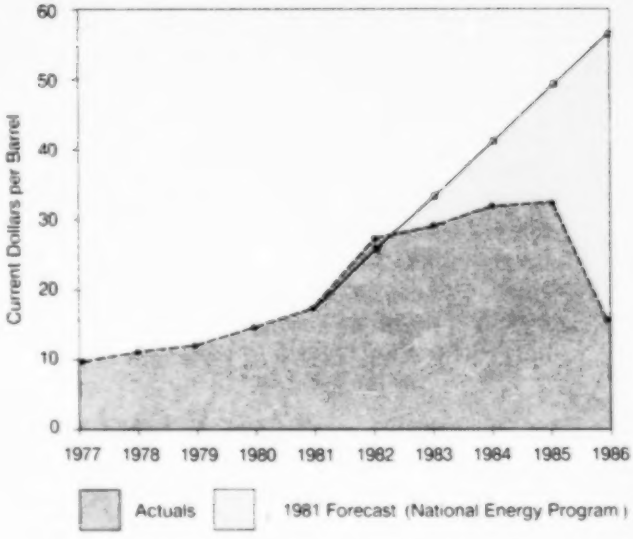
- oil revenues were projected to **increase** by almost 180 per cent, in actual fact they have **declined** by 58 per cent;
- potash revenues were projected to **increase** by almost 220 per cent, in actual fact they have **declined** by over 80 per cent; and,
- uranium revenues were projected to **increase** by over 350 per cent, in actual fact they have **declined** by over 40 per cent.

Falling world commodity prices and grain "trade wars" have taught us that we can no longer count on continuous increases in international commodity prices to fuel economic growth. Our ability to produce export commodities at competitive prices continues to provide a sound foundation for the provincial economy. However, commodity prices have not lived up to the expectations of the late 1970s and early 1980s. Price deflation now governs our trading environment.

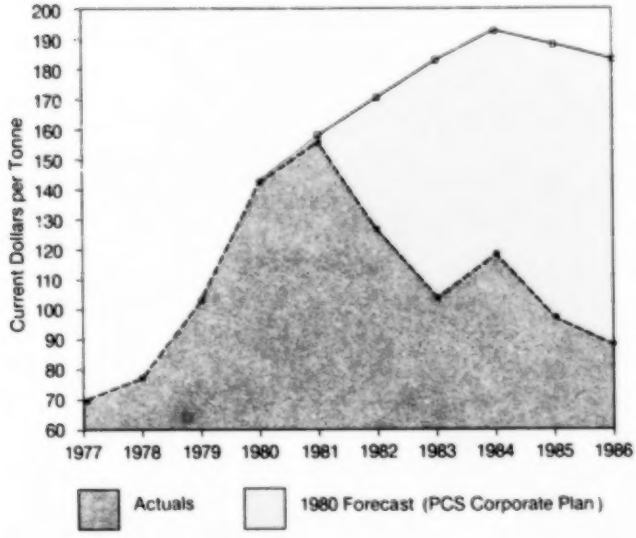
Wheat Prices



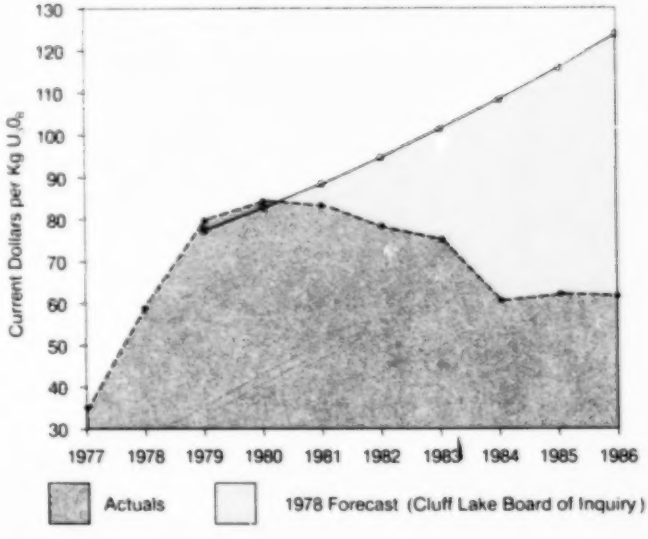
Oil Prices



Potash Prices



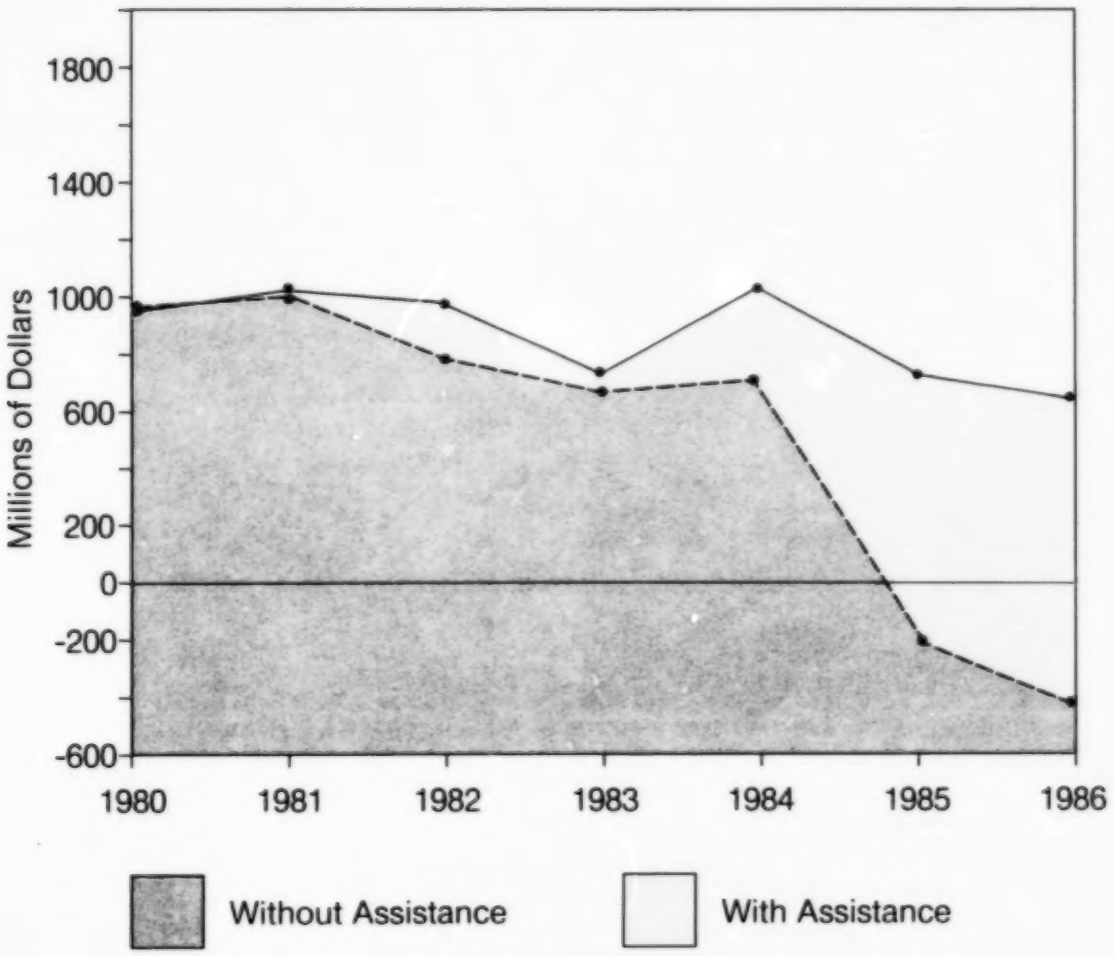
Uranium Prices



In responding to these and other changes in the world economy, the Saskatchewan Government in 1982 adopted a strategy designed to build on our existing strengths while creating an environment favourable to new areas of economic development. This strategy emphasized the role of the Saskatchewan people in shaping their economic future. The Venture Capital Program, the sale of Saskoil and Sask Power securities, the Stock Savings Plan are but a few examples of the success of the Government's people-orientated economic diversification strategy. This strategy has been bolstered by major projects such as the NewGrade Upgrader and the Prince Albert pulp and paper mill. Agriculture processing, new technology investments and the development of a more highly skilled workforce have further enhanced this diversification strategy.

However, since 1982, the decline in world commodity prices and other negative factors beyond our control have placed increasing pressure on certain sectors of our society. Saskatchewan government programs, such as the Mortgage Interest Reduction Program, the Production Loan Program and the Oilfield Employment Program, instituted over recent years, did much to protect these sectors from factors beyond our control. Indeed, if it had not been for government-established programs, realized net farm income in Saskatchewan would have been substantially below zero in recent years.

Realized Net Farm Income



The challenges to our economy continue. Consequently, we must continue to respond with strength and vision. We must pursue our strategy, as stated in the Speech from the Throne, to intensify our efforts to assist individuals, communities and businesses in the development and diversification of the provincial economy while maintaining our commitment to protect people from events beyond their control. Our Saskatchewan Builds initiative is designed to diversify the economy, to improve the international competitiveness of our industries and to increase the participation of all our citizens in Saskatchewan's economic growth. We are also working hard at home and abroad to put in place a comprehensive agricultural development strategy. Excellence in education, new health care initiatives and the continuation of welfare reform are examples of the recent commitments we have also made to enhance the protection of our citizens.

The Government recognizes, however, that it must continue to improve public sector efficiency in the face of sharply declining revenues. An expanding government program base without secure and appropriate financing will hinder future economic growth. Unless we take meaningful fiscal action now to increase government efficiency and control the deficit, we will not have the flexibility to address public priorities or be in a position to take full advantage of the economic opportunities that will present themselves in the coming years.

Government Management

Current Fiscal Situation

The deficit for 1986-87 is currently forecast to be $1.2 billion, about $800 million over the budget figure of $389 million. This increase is due to many factors, some of which were beyond the Government's control.

The revenue shortfall, relative to our initial estimate, is approximately $500 million. This decline in revenue is primarily due to three factors:

- a $350 million drop in resource revenues led by the severe oil price decline;
- a $60 million reduction in the estimated value of Land Bank land transferred to the Agricultural and Commercial Equity Corporation caused by dropping land values in the farm sector; and,
- a $100 million reduction in the transfer of liquor board profits based on our need to provide flexibility for future years.

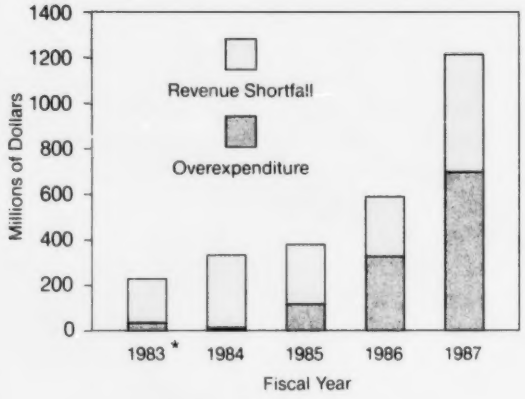
In addition, estimated expenditures are forecast to exceed our original target by $300 million. Expenditure increases can be attributed to:

- $120 million in increased expenditures associated with the Home Program;
- $110 million in increased expenditures, at the request of the Provincial Auditor, to provide for loss exposure associated with the Production Loan Program in the event these loans are not collectible; and
- $70 million in miscellaneous overexpenditures driven substantially by student aid, social assistance, the prescription drug plan, highways capital and salary settlements in the health care sector.

As well, on the Provincial Auditor's advice, we have been forced to write off losses totalling $45 million, for SEDCO, the Saskatchewan Forest Products Corporation and the Saskatchewan Transportation Company.

The following chart illustrates the causes of the growing deficit since 1981-82.

Components of the Deficit



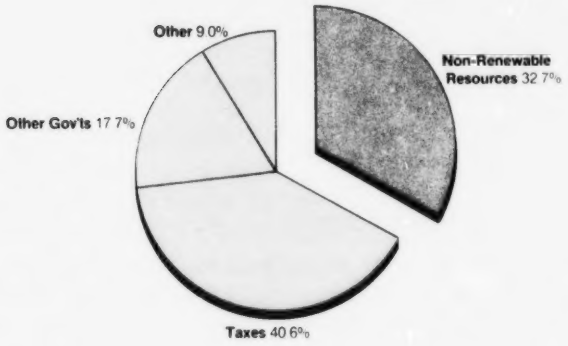
* In this fiscal year the previous administration overstated revenues and understated expenditures by a total of $250 million

Despite strong management, our deficit has grown because of revenue shortfalls and the concurrent demand for increased expenditures. If we are to ensure a stable financial base for the 1990s, we must improve further the financial management of the public purse.

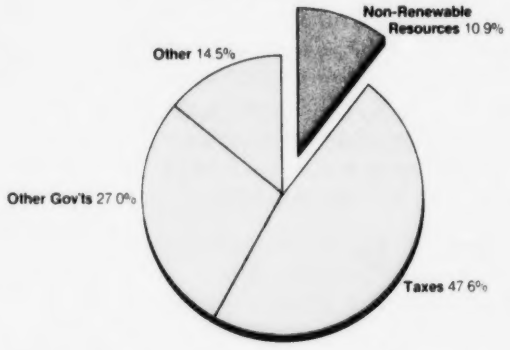
Revenues

Our revenues reflect the reality of world market prices. In 1980-81, the province received nearly 33 per cent of its revenues from non-renewable resources. In this fiscal year, we expect that non-renewable resources will yield less than 11 per cent of our total revenues.

Revenue Composition 1980-81
Shares of Total Revenues



Revenue Composition 1986-87
Shares of Total Revenues



- From 1980-81 to 1986-87, potash revenues have declined from $280 million to $35 million — a drop of nearly 88 per cent.
- Oil revenues reached $700 million in 1982-83 and continued to grow until 1984-85 when they exceeded $740 million and accounted for over 25 per cent of provincial revenues. Recently, however, oil prices have fallen at an unforeseen, dramatic rate due to excess world oil supplies. Our current expectations are that oil revenues will be $220 million in 1986-87 — down over 70 per cent from the peak of 1984-85.
- The softness in international uranium markets also has adversely affected provincial revenues. In 1985-86, we received over $36 million from royalties and taxes on uranium. This year, our uranium revenues have fallen by more than 50 per cent.

Low commodity prices also have affected other revenue bases. Based on a federal re-estimate, Saskatchewan's Corporate Income Tax collections are now expected to be about $50 million less than the original 1986-87 estimate.

Falling commodity prices also led to reduced incomes, slower consumption and investment. Consequently, we now expect to collect about $25 million less than we had originally expected from sales taxes in this fiscal year.

The drop in the value of our resource bases together with strong growth in the central Canadian provinces has led to a readjustment in the payments under the federal equalization program. Prior to 1981-82, Saskatchewan was a recipient of equalization payments in all but one year. In the four years from 1981-82 to 1985-86, Saskatchewan's robust oil industry made us a "have" province for the purposes of equalization. However, with the fall in world oil prices, Saskatchewan's will again receive equalization payments in the order of $147 million for 1986-87. Since we are making the last $23 million installment in the repayment of an outstanding liability of the previous administration, we will therefore be receiving a net payment of $124 million from the federal equalization program for 1986-87.

The overall effect of these and other changes to our revenue forecast will be to leave the Province with revenues of approximately $500 million less than we had originally anticipated. The conditions which have led to this drop in revenues will be with us for some time. Improvements in resource prices are necessary before the revenue growth rates of the early 1980s return.

In spite of these difficulties, Saskatchewan is fortunate to have such a rich and diverse resource base. Resources have allowed us to achieve one of the lowest personal tax

burdens in Canada. Even this year with the combined impact of simultaneous "bottoming out" of resource prices, our non-renewable resources will provide us with over $300 million in revenues. This is $300 million that many other provinces do not enjoy and it gives Saskatchewan a comparative revenue advantage.

Expenditures

During the 1970s, governments in Canada devoted even more energy to the distribution of wealth than any time previously. Economies were generally healthy and governments responded by ensuring that all elements of society benefited from this prosperity. Expenditure growth during this period in Saskatchewan exceeded inflation by an average of 7.3 per cent per year. By 1980 Saskatchewan had in place one of the richest open-ended program bases in Canada.

Since the early 1980s, however, the issues facing governments in Canada have changed. The downturn in the Canadian economy, and its slow recovery, has meant that governments have been forced to reduce expenditure growth. Saskatchewan was not an exception. Nevertheless, in critical areas expenditures have been maintained and at times significantly increased.

- In health, total expenditures have increased by 63 per cent from $715 million in 1981-82 to $1,166 million in 1986-87.
- In education, total expenditures have increased from $512 million in 1981-82 to $702 million in 1986-87. On a per student basis this represents a 37 per cent increase.
- In agriculture, expenditures have increased by 327 per cent from $76 million in 1981-82 to $325 million in 1986-87. Agricultural expenditures now total $5,400 per farmer.

Expenditure growth over the past four years has been largely sustained by steady and significant increases in government borrowing, not by increases in revenues. This situation presents us with a serious challenge. We must rationalize our current spending patterns to ensure that they continue to address real public needs and match even more closely current and anticipated revenues. This is the challenge that the Government has set for itself, a challenge that will require trade-offs and a spirit of goodwill and co-operation.

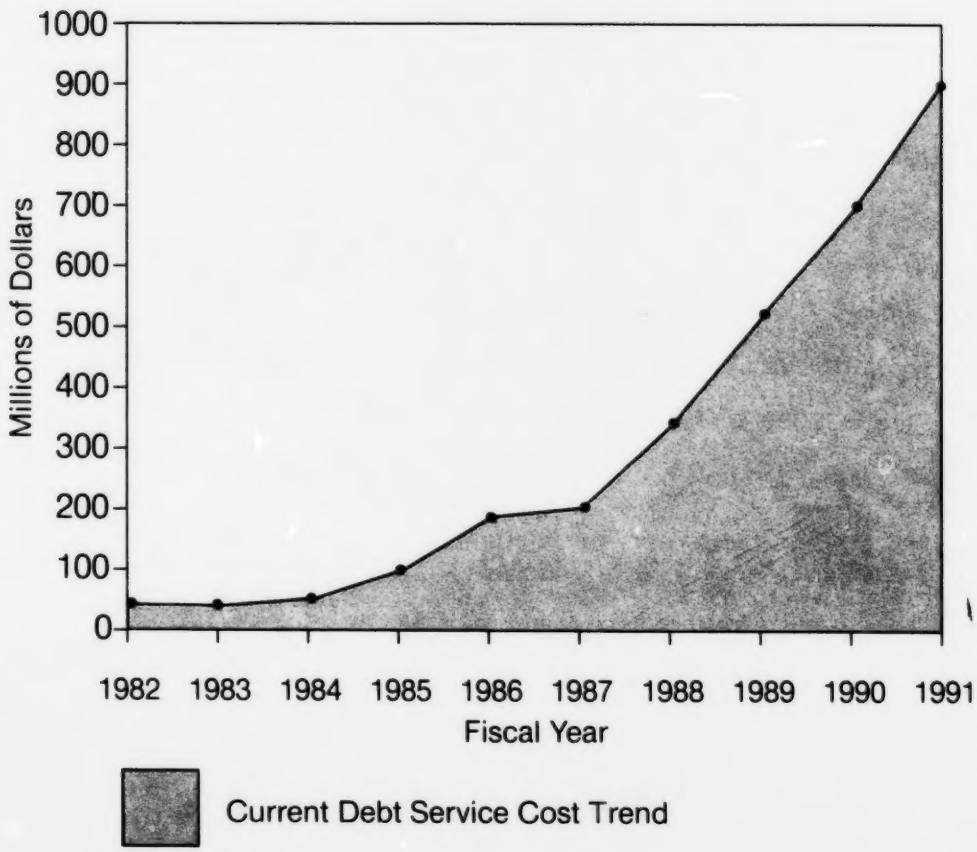
Fiscal Responsibility

The Government of Saskatchewan has implemented numerous initiatives over the last several years to improve the efficiency and effectiveness of government. In 1983, a major reorganization of government departments and agencies occurred that resulted in the amalgamation of several agencies and a much clearer definition of responsibilities. Just recently, two new departments, the Department of Human Resources, Labour and Employment and the Department of Environment and Public Safety, were formed by combining five separate departments and agencies.

The Government also has acted to reduce the size of the public service. Between 1982-83 and 1986-87, the number of government employees has decreased by over 1,000 — a reduction of seven per cent. In addition, the Government has negotiated fair but financially responsible wage settlements with its employees over the past four years.

Despite these measures, the Government recognizes that further efficiencies are required. If no steps are taken, it is projected that the deficit will be $1.5 billion in 1987-88. Should this deficit trend continue we can expect debt service costs to total nearly $1 billion by 1990-91. These payments would exceed our total current expenditures on K-12 education, post-secondary education, highways and housing.

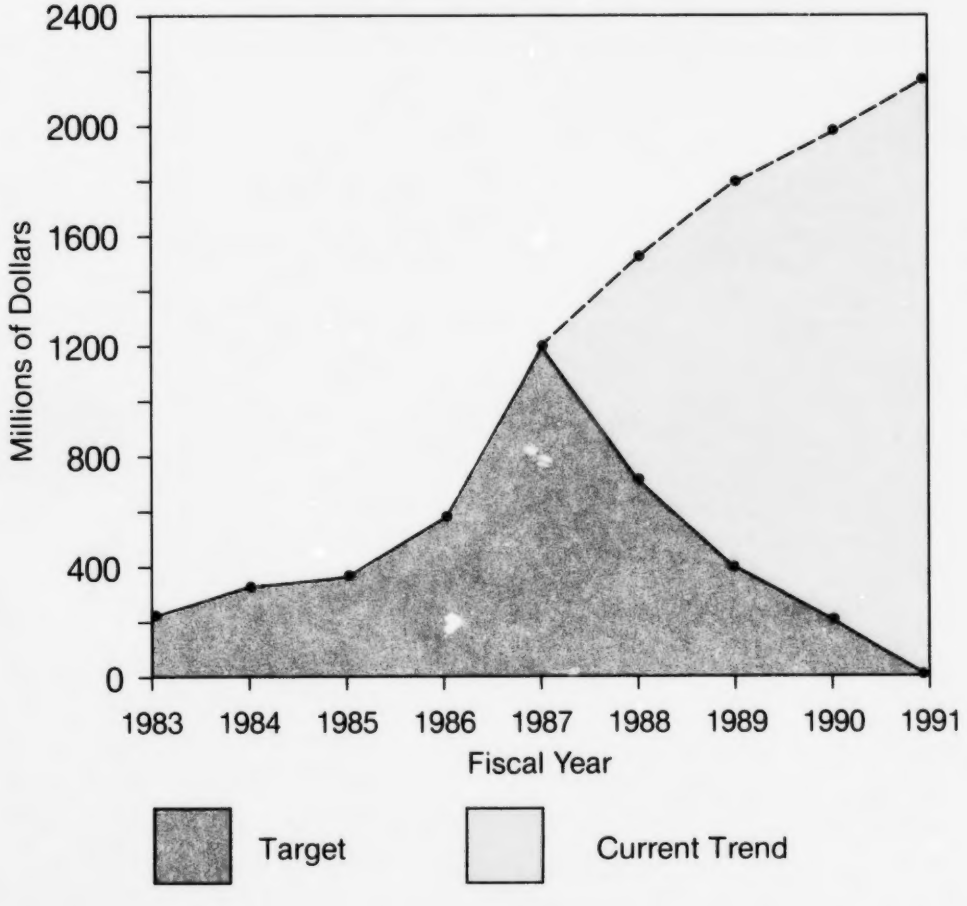
Debt Service Cost Trend



It is the Government's intention to significantly reduce the projected deficit. For 1987-88, a deficit reduction target of $800 million has been established and further reduction targets will be set in each of the next few years with a view to balancing the budget by 1990-91.

To achieve our reduction target of $800 million off the 1987-88 projected deficit of $1.5 billion, we will direct our energies towards reducing government expenditures before any revenue initiatives are contemplated.

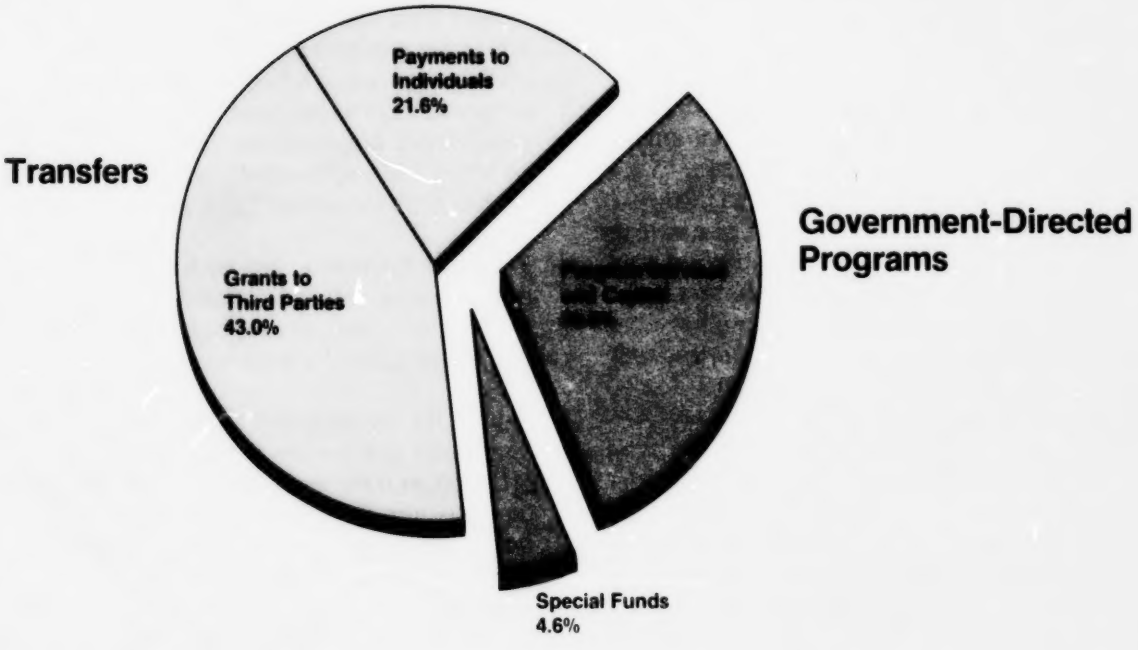
Deficit Scenarios



Spending can be categorized into two major groups. The first is transfers which includes grants to third parties and payments to individuals. In 1986-87, approximately two-thirds of the budget consisted of transfers. The second is government-directed programs which includes the operating and capital costs of services and the interest costs on the public debt, estimated at $200 million. Total government-directed programs account for the other third of provincial government expenditures.

Expenditure Composition 1986-87

Shares of Total Expenditure



Government services and departments will be the focal point of our efficiency initiatives in order to capture as much of the $800 million reduction target as possible from this portion of the government's expenditure package. Wage increases for government employees will be held at a maximum of zero per cent for at least the next two years. As other public and Crown sector contracts expire the same wage policy will apply. Regarding the current labour dispute with Sask Tel, government policy will be announced as it applies to that particular situation at an appropriate future date.

We anticipate that the size of the public service will be further reduced by up to 2,000 positions. We should emphasize that this reduction will be largely accomplished, as it has been in the past, through the prudent management of attrition and early retirement. We will be using this as an opportunity to rejuvenate the public service. While the Government recognizes the need to create as efficient a public service as possible, we also recognize the tremendous contribution and commitment made by individual public servants. Personnel reductions must and will be handled in a fair and just manner.

In addition to improving administrative efficiency, the Government is reviewing all programs. If it is concluded that a program is no longer essential in today's environment, or is not achieving its purpose, it will be eliminated. If it is concluded that a program is essential, the Government will try to find ways to reduce the cost of delivering it. As well, opportunities to achieve efficiencies through private sector delivery will be aggressively pursued.

Given that two-thirds of provincial government expenditures consist of transfers, it will be necessary for individuals and third parties to assume some responsibility for deficit reduction. As is the case with the provincial government, third parties have an obligation to the taxpayers of the Province.

Our intention is to hold the operating grant pools to schools, hospitals, municipalities and universities up to a maximum of zero per cent in 1987-88 and 1988-89. As is the case with government employees, funding for third parties for the next two years will not recognize salary increases. Grants for school, university, hospital and nursing home construction projects are currently being reassessed. It is likely that some of these projects will have to be deferred. We are also examining the rationalization of municipal capital grants.

Other third party groups will receive less than zero per cent in 1987-88 unless they are able to demonstrate that this reduced funding level is not feasible. These groups, many of which receive their entire funding from the provincial government, will be asked to undergo the same internal reassessment and rationalization as we have asked of government departments. Funding levels to be set in 1987-88 for these groups are likely to set the base for similar funding in 1988-89.

Increases following 1988-89 for all third party organizations will depend on the strength of the economy and, in particular, the strength of the agricultural economy.

Finally, the Government is concerned that all third party groups use Saskatchewan products and services wherever possible. If it becomes apparent that best efforts are not being made, we will consider making grants contingent on the use of Saskatchewan goods and services. A commitment to the building of the Saskatchewan economy is the responsibility of us all. This is particularly true where operational and capital funding is provided by the taxpayers of Saskatchewan.

The success of our endeavours to restrict government costs in all areas will determine the need to examine our revenue base. If revenue initiatives are required, the Government will look to three general sources.

One of the Government's priorities will be to institute more equitable and reasonable charges for certain non-essential government services. Some services are currently

provided to select groups at no charge. Fees are charged for some other services, but the amount of the fee is dwarfed by the cost of providing the services and/or the value received. Another priority will be to intensify our efforts to capture Saskatchewan's fair share of federal transfer payments, including funds under the equalization program. The Government also will attempt to maximize federal contributions under existing and upcoming cost-sharing agreements.

The Government intends to raise general tax rates only as a last resort. If any taxes are raised, the increases will be for a limited duration only and for the specific purpose of addressing our deficit problem. Consistent with the Government's commitment to tax reform, the priority will be on fairness so that, wherever possible, any additional tax load will be borne by those who can most afford to pay.

In summary, the Government will take efficiency measures within its own expenditure base to reach the $800 million target before it asks others to make sacrifices. This will be accomplished by furthering our efforts at reducing the size of the public service, achieving administrative efficiencies and streamlining program services.

Conclusion

Despite the downturn in our resource-based economy some sectors continue to perform well. For example, Saskatchewan's service sector activity increased 3.7 per cent in 1986, a substantially higher rate than our average job growth rate of 1.1 per cent. Manufacturing diversification continued with recent investments in pork processing and chemicals manufacturing facilities. Construction activity is also holding its own. During the final three months of 1986, Saskatchewan posted the strongest proportionate increase in housing starts in Canada.

The strength of our non-resource sectors has also been reflected in Saskatchewan's excellent labour market performance. Last year our unemployment rate dropped to 7.7 per cent, down from 8.1 per cent in 1985. Job expansion continued. Between 1981 and 1986, employment in our province rose 7.5 per cent, compared to a national average increase of only 5.7 per cent.

However, it is also the case that the Province now finds itself with a rapidly growing deficit largely due to falling prices for all our basic export commodities.

As a consequence:

- provincial government expenditures have continued to increase relative to GDP; and,
- the accumulated debt has grown rapidly in recent years.

It would be comforting to believe that we would eventually grow our way out of our current deficit problem — that prices for all our export commodities would return to 1981 levels. Yet given the global economic restructuring presently underway, this is not likely — at least in the near future. Accordingly, we must be realistic. We must learn to provide for real public needs within the framework of funds currently available. We must spend public funds even more wisely and increase government productivity.

Addressing our financial situation now will protect the quality of our health, education and social support systems that we all depend on. It will also give us the financial flexibility to cope with future economic adjustments and the financial stability to meet the challenge of a much tougher and more competitive global economy.

Accordingly, it is the Government's intention to rationalize the scale of government, to define better what we as people want and to develop a fair way to pay for it all. To be sure, this will involve trade-offs and require a spirit of goodwill and co-operation. And although reasonable people may disagree over the details, given the nature of our current financial situation, it is clearly desirable to phase in a set of realistic measures over the next few years.